

THE ASIAN FINANCIAL CRISIS AND POLICY RESPONSE IN THE PHILIPPINES

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Both in-country and regional evidence show that the Philippines did have the symptoms of the "Asian flu" before its outbreak into a full-blown Asian financial crisis. Although it cannot be validated (in a counterfactual sense), one can argue that it may have been the early start of the crisis elsewhere that now makes the country face less harsh consequences and adjustment. The Philippines is therefore not just an innocent bystander in the confluence of events in the region. This conclusion does not diminish the task of defining policies to address the root causes of the crisis and to adjust to the environment it creates. In terms of policy response, it may have been a blessing in disguise that the country did not have sufficient reserves to put up a defense early on. It is this which paved the way for the actual policy of freeing the exchange rate, rather than a conviction that the exchange rate should not be a target. Indeed, there are policies which are vestiges of this defense mechanism still in the books (e.g., interest rate cure). On the other hand, there remains a policy vacuum in the area of financial sector reforms, the very area that appears to be where the crisis started in the Asian region.

1. Introduction

Ever since the outbreak of the financial crisis in Southeast Asia and its spread into East Asia, there have been numerous accounts, analyses, dissection, prescription, and recommendations on the underlying problems. The Philippines has not been spared from this avalanche of experts, informed opinions, technical papers, government documents, and other materials. This has made the understanding of the crisis take extreme directions—either one is enlightened or confused. Add to this the regional context, and thus the comparability, and the picture often becomes blurred simply because as other countries are included in the accounts the factual information may not be commonly sourced and it tends to have many and varying definitions.

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PHILIPPINE POLICY RESPONSE TO THE ASIAN FINANCIAL CRISIS

It is true that as a result of the abundance of information and sudden deluge of expertise there is greater enlightenment if not the acquisition of some common knowledge of the crisis in the region. But how accurate the understanding and enlightenment is then becomes more difficult to distinguish and one must perforce separate the "chaff from the grain." Moreover, without any serious framework to go on, the information binge is a matter of gathering facts. Over time, we should be seeing attempts at looking at the crisis from a more deliberate and "analytic" perspective (e.g., Krugman, 1998).

What one observes in the Philippines is that the crisis is viewed from at least two standpoints. On the one hand, there is the view that the country is simply an innocent bystander to an economic problem that is in other countries. Even if the Philippines is indirectly affected, it has already taken the necessary policies to withstand a potential injury. For a time during the immediate aftermath of the crisis in July 1997, even President Ramos subscribed and propounded this view. A cursory look into government pronouncements indicates that the Philippines should simply "stay on course" and the country should weather out the storm. The country's "fundamentals" are correct.¹ On the other hand, there is the view that these fundamentals were weak to begin with and the crisis only served to highlight them despite the respectable performance of the economy in the last few years. Lost in the debate between these views is a trace of how the country actually responded to the crisis. Indeed, these differing views begin with a different picture of the economy, which partly accounts for the difference in the way the crisis is viewed.

At the risk of being another information piece, this paper aims to examine the Philippine context of the Asian financial crisis and describe the country's policy responses. This context is seen in terms of how this crisis has affected the Philippines since its explosion in 1997 without having to settle the opposing views noted above. We try to document the various explicit policy responses to the crisis that have been taken by the government, and the implicit policy moves that are evident in the behavior of the economy in the period after the onset of the crisis. Thus, in the next section, we piece together the manifestations of the crisis in the Philippines. The thrust of the section is the argument that the country already had the "symptoms" of

¹ The meaning of "fundamentals" is never clear in the literature that has exploded on the crisis. Presumably, this means conservative governments (meaning low budgetary deficits (if not surplus), high savings rate, and high productivity).

the "Asian flu" before the crisis erupted in Thailand; that a major reason why these did not break out into a major condition is that the country had not had a substantial and lengthy exposure to the virus; that had the symptoms dragged on, the country could have sparked a crisis of its own. In general, because of late exposure of the country to the Asian flu the regional crisis did not inflict as much damage than if it had occurred later. Nevertheless this is not to say the country was an innocent bystander. Indeed the adjustments the country has undertaken and need to undertake parallel those that the other countries are following.

A regional context is given in the third section that effectively situates the country's experience with other countries in terms of the crisis symptoms. The data seem to show that the country was indeed less exposed to the latent manifestation of the crisis in the region. This means that if the trend had continued the Philippines would start to display more prominently the characteristics found in the other countries in the region.

In the fourth section, we trace the various policy responses of the Philippines to the regional financial crisis. The crisis created a contagion effect on the Philippines and the policies came in many modalities. There were policies the country immediately took when the contagion began, there were those that were aimed at the financial sector, and those that passively battled the contagion. Finally, there are policies that need to be considered as well as policies that appear to have been wrongly taken. In general it is argued that while the overall policies may have been appropriate (thus avoiding magnified repercussions under alternative policy scenarios) some are unnecessary and impose unwarranted side effects. On the other hand the crisis calls for other policies which have yet to be considered.

In the final section, some conclusions are drawn from the crisis and the Philippines response to it. While the apparent responses have, in general, been supportive of an adjustment process, there remain lingering concerns about them. The more hidden potential response however is the one that needs to be addressed squarely. This pertains to possible options of reinstituting controls or delaying the further liberalization of the economy and the country's participation in globalization. There are macroeconomic ways to safeguard against the volatility of capital flows without necessarily diminishing a sustained commitment to openness.

2. Crisis Manifestations in the Philippines

Without having to impute causality to the indicators, there are several symptoms of the crisis. Among them are (a) the surge of short-term capital mostly in the form of portfolio investments relative to the flows of foreign direct investments, (b) a bubble in the economy shown by exuberance in the stock markets and price inflation of real estate and nontradables, (c) the rapid expansion of domestic credit extended by the commercial banking system, (d) a widening current account deficit, and (e) an overvaluation of the local currency. It will be recalled that these are also, but not exclusively, the same symptoms of the Mexican crisis in 1994.

The Philippine experience with short-term capital inflows has been relatively recent. In fact, the portfolio capital component of them was negligible before the 1990s. Yet this surged beginning 1993. From US\$ 156M in 1990 this rose to US\$ 6.9B in 1996. Figure 1 shows the inflow of foreign investments in the Philippines. Notice the sharp increase after 1992 with a consequent scaling down of foreign direct investments.

Apart from the inward flows of short-term portfolio investments, the country's financial institutions also tapped the global markets for both short-term and long-term foreign exchange resources. In the former, borrowings were utilized to take advantage of interest-rate differentials and the stable exchange rate for onward lending to local borrowers in local currency. For the latter, the institutions floated long-term bonds in international markets. Again the data show that borrowings, especially by banks, did surge but only beginning 1995. Figure 2 tracks the foreign exchange liabilities (short and long term) of banks and non-banks. Total liabilities stood at US\$ 4.7B in 1993 and surged to US\$ 17.8B by 1997 (June). Though there may be issues here with regard to the use of Foreign Currency Deposit Unit (FCDU) of offshore banks in the Philippines, the fact is that borrowings by the private sector escalated in two years between 1995 and 1997.

Portfolio investment inflows in the Philippines have found their way into the property sectors, in the stock markets, or in financial institutions, among others. Driven by continued privatization of public enterprises, initial public offerings by corporations, and overall "irrational exuberance," these investments drove up asset prices and created large paper gain in the stock market. Figure 3 shows the movement of the Philippine stock exchange index from the time the First Philippine Fund (FPF) was floated in the New York Stock Exchange. Notice the surges in the index occurring after 1992.

Figure 1.
Foreign Investment
(Million US\$)

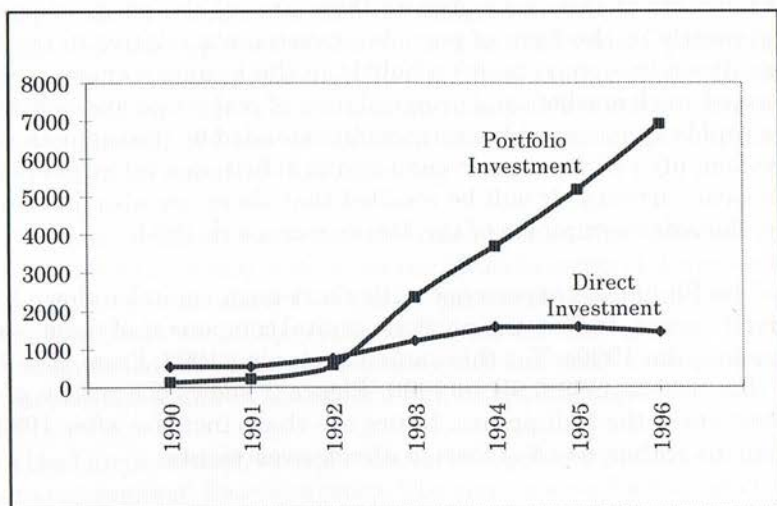
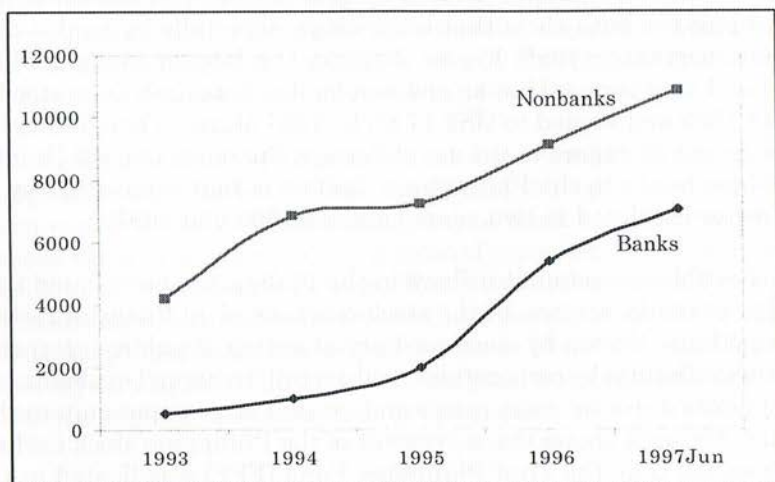
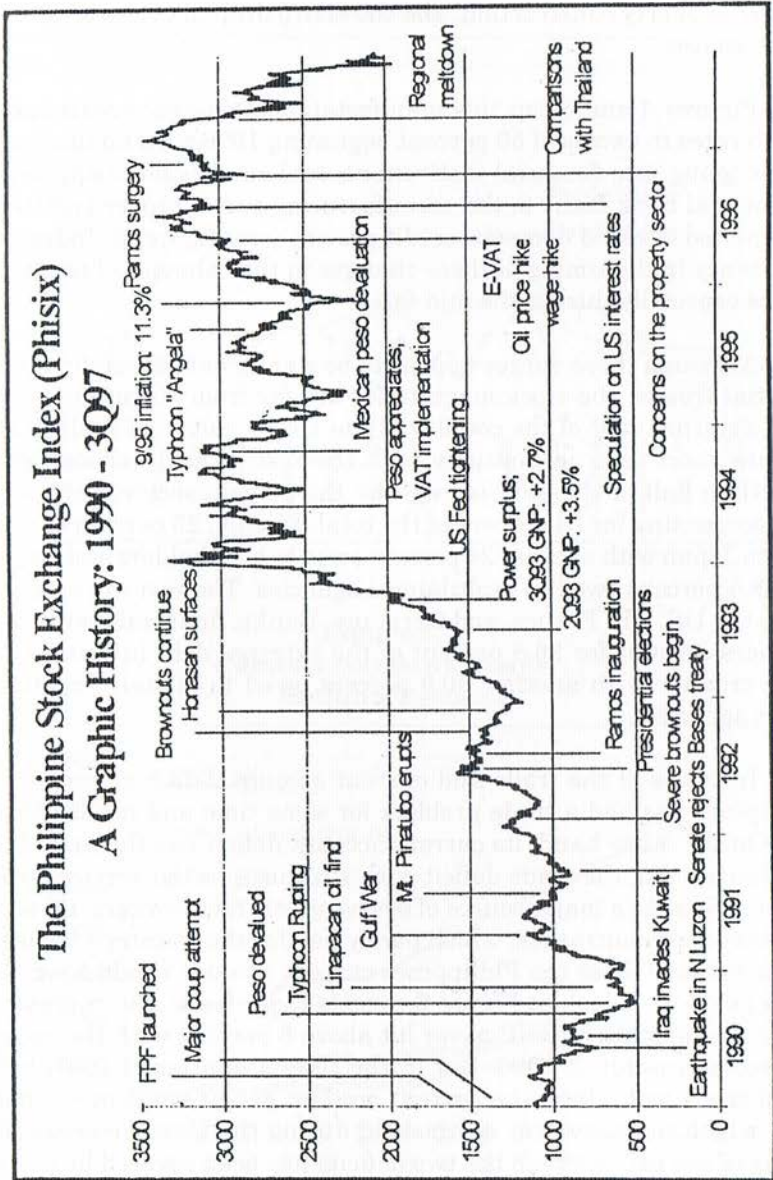


Figure 2.
Foreign Exchange Liabilities
(Million US\$)



Source of Data: Bangko Sentral ng Pilipinas

Figure 3.



Evidence of the property bubble can be readily observed in the rapid decline in property prices around the prime areas of the country, the shelving of planned property construction, and the sharp drop in prices of club and golf course shares.

Figures 4 and 5 cap this manifestation. Domestic credit had annual growth rates in excess of 50 percent beginning 1996 with an increasing proportion going into financial institutions, real estate and business services. Commercial bank loans to the manufacturing sector tapered off during the same period of rapid domestic credit growth (see Figure 5). Indeed there is consistency in the timing of these changes in the behavior of financial institutions especially during the mid-90s.

Although these surges appear to be significant especially if viewed in potential trends, the stock magnitudes are far from alarming. Of the US\$ 44.8B external debt of the country (June 1997), only US\$ 8.5B or 18.9 percent are short-term in maturity with the rest in medium and long terms. More than half of the debt is owed by the private sector with the central bank accounting for 24 percent of the total. Finally, 25 percent of the debt is owed to Japan with another 24 percent owed to bondholders and noteholders and 18.5 percent owed to multilateral agencies. The rest are spread evenly across the US, UK, France, and Germany. Banks, financial institutions, and suppliers account for 26.8 percent of the external debt in terms of institutional creditor with another 30.3 percent owed to bilateral agencies (e.g. export agencies).

In terms of the trade and current account deficit characteristic, the Philippines has had a trade problem for some time and it has been persistent. On the other hand, its current account deficit has fluctuated over the years narrowing the trade deficit with surpluses in the services trade, and net transfers. As a major source of overseas contract workers, these Filipino workers send remittances, which partly pay for the country's trade deficit. In fact without these the Philippines current account would have been in a worse position. A look at Figure 6 reveals these facts. The current account deficit as a percent of GNP never hit above 6 percent with the exception of the second quarter of 1996. But in the second quarter of 1997, before the actual crisis took place, the current account deficit stood at 6.7 percent of GNP, which somehow was a threshold during the Mexican crisis. The narrowing of the gap between the two deficits has been covered by the surge in the net services trade. For example, this item had an inflow of US\$ 4B in 1994 from US\$ 1.5B in 1990.

Figure 4.
Growth of Domestic Credit
(percent)

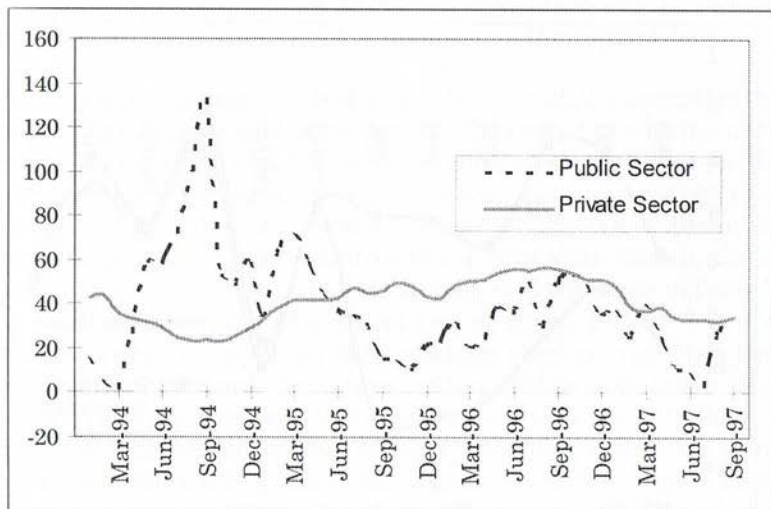
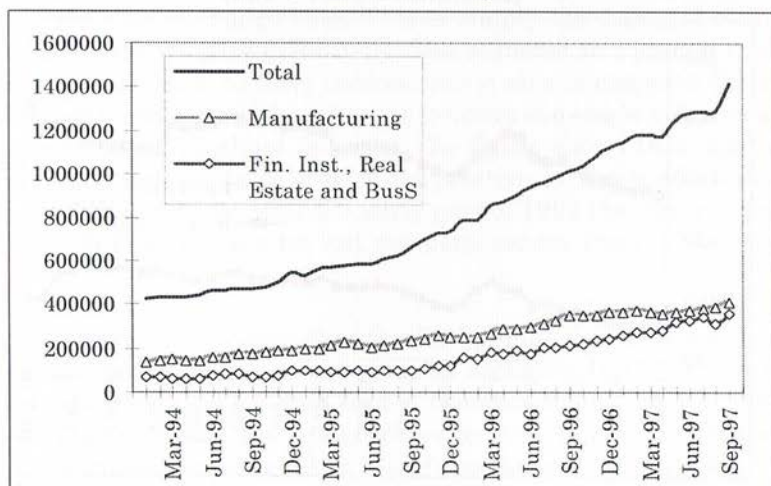


Figure 5.
Commercial Bank Loans
(Million Pesos)



Source of Basic Data: Bangko Sentral ng Pilipinas

Figure 6.
Trade and Current Account Deficit
(Percent of GNP)

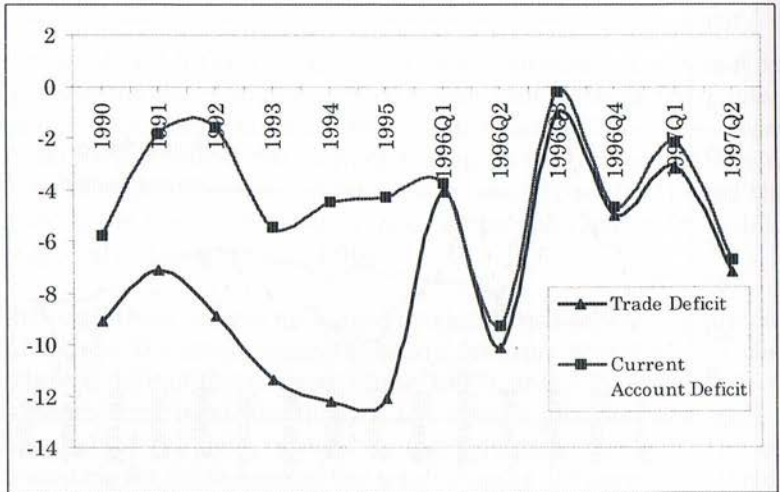
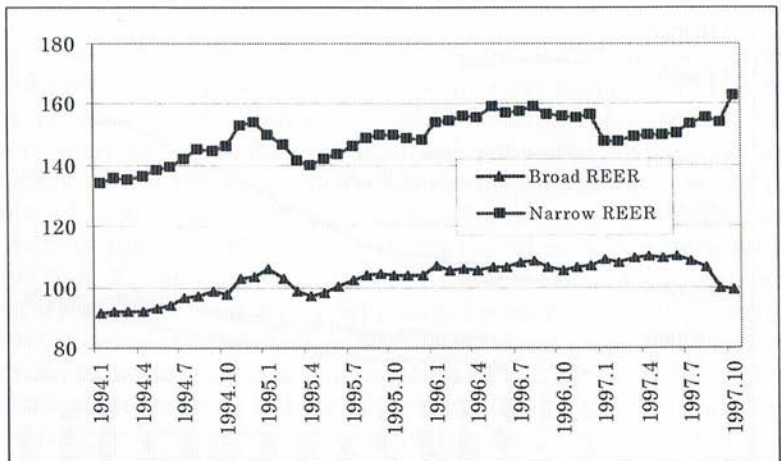


Figure 7.
Real Effective Exchange Rate Index
(December 1980 = 100)



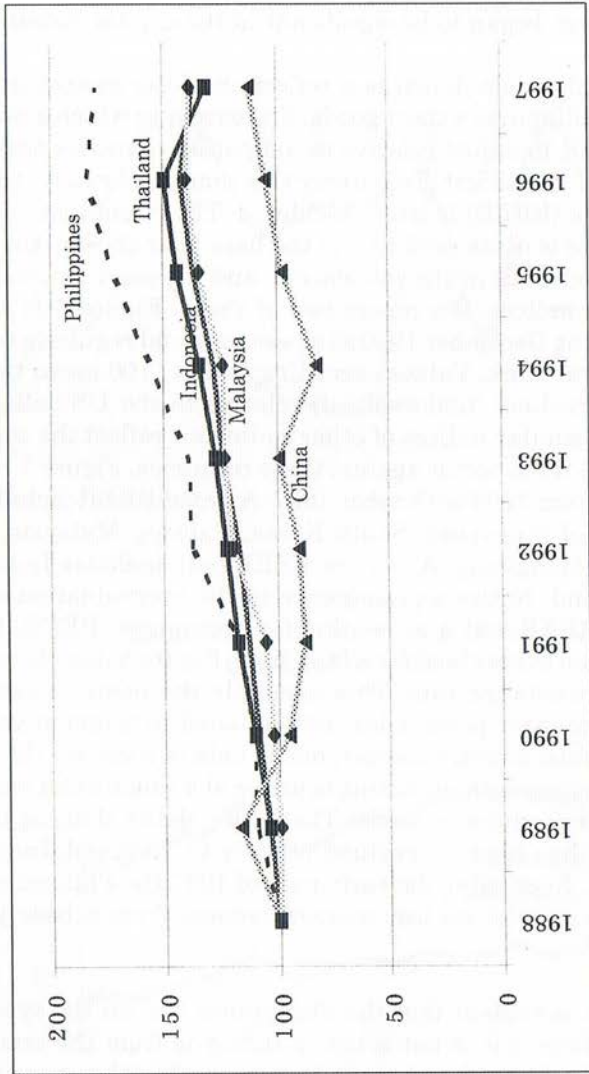
Source of Basic Data: Bangko Sentral ng Pilipinas

The overall Balance of Payments (BOP) of the Philippines has been positive for most of the years between 1990 and 1996 principally because of a positive capital accounts position. In turn this has been carried by more significant inflows of medium- and long-term loans. It is only in 1995 when the net portfolio account began to be significant in the capital accounts.

A widening goods trade deficit is a reflection of the competitiveness (or lack of it) of the Philippines' export goods. The extent to which a nominal exchange rate is unable to adjust relative to competing countries partly determines the extent of the deficit. To portray this more accurately, the real effective exchange rate (REER) is often calculated. The calculation of a real effective exchange rate is quite sensitive to the base year chosen, the countries included (and excluded) in the calculation, and the price indices. Thus there are many such indices. We report two of these. Figure 7 is a more conservative index using December 1980 as a base year and regularly tracked by the country's central bank. Values exceeding (below) 100 mean that the local currency is overvalued (undervalued) relative to the US dollar and, when compared with similar indices of other countries, reflect the competitiveness of the overall trade sector against these countries. Figure 7 reports two monthly indices from 1994 to October 1997. A broad REER includes the competing countries of Singapore, South Korea, Taiwan, Malaysia, Thailand, Indonesia, and Hongkong. A narrow REER only includes Indonesia, Malaysia, and Thailand. Notice a prominence in the overvaluation only in late 1995 for broad REER and a worsening for the narrow REER. In any event the peso has been overvalued for a long time. Figure 8 depicts another calculation of a real exchange rate. This is simply the nominal exchange rate deflated by the country price index and adjusted to common year. By showing these individual country indices, one is able to compare the movement of the index over time without having to arrive at a single index weighted by the partner country's share in trade. The figure shows that, again, the Philippines currency has been overvalued relative to Thailand, Indonesia, Malaysia, and China. Even after the early part of 1997 the Philippines still has not been able to recover its lost competitiveness from a base year of 1988.

In summary, it is evident that the Philippines had all the symptoms of a financial crisis even if it is not actually suffering from the crisis that exploded in the region. What has kept it from acquiring the severity that others have experienced is the late exposure to the symptoms. This does not mean that the measures being taken to address the root causes of the "Asian flu" should not be applicable to the country as well.

Figure 8.
Real Exchange Rate Index



3. Regional Context

This section briefly situates the Philippines in the overall context of the East and Southeast Asia. What we want to show here is that not only has the Philippines been exposed to the symptoms late but that the magnitude of its exposure has been small compared to her neighbors. Figure 9 presents the flows of portfolio investments into Indonesia, Korea, Malaysia, Philippines, and Thailand between 1989 and 1996. Keeping in mind some of the data qualifications,² Korea, Indonesia, and Thailand continued to experience surges of portfolio capital well beyond 1994 after dipping from a peak in 1993. The Philippines can be seen to have been a negligible absorber of such capital during the same period.

The associated reductions in foreign direct investments are apparent only in Thailand and the Philippines although inflows into Korea are only a fraction of the portfolio type of inflows. In the case of Indonesia and Malaysia, foreign direct investments remained substantial and were not substituted by the flows of portfolio capital.

The combined net private flows into the region are shown in Figure 11. Note the escalation of the flows in 1993 or 1994 with the exception again of the Philippines. It is important to emphasize that net private flows other than foreign direct investments into the developing member countries of the Asian Development Bank were twice the foreign direct investments in 1995 (which amounted to US \$52.8B). When set against official flows of US \$18.7B in 1995, private foreign capital has become an important source of foreign savings.

Figure 12 presents the domestic credit to GDP ratio for the four ASEAN countries, which have been affected by the financial crisis. Here the recent rise in credit growth in the Philippines stands out from among the four countries even when compared to Thailand. While Thailand did expand in 1992, it had tapered off by 1995 and 1996. On the other hand, credit expansion in the Philippines had just started with a steeper rise both in 1992 and in 1995. This particular characteristic in the Philippines merits an observation. A credit growth accelerating at a pace faster relative to the normal

² The data used here come from the set assembled by ADB in its Key Indicators of Developing Asian and Pacific Countries which sometimes differ from the country statistics (which should not) because of timing and differences in definition.

Figure 9.
Portfolio Investment
(Million US\$)

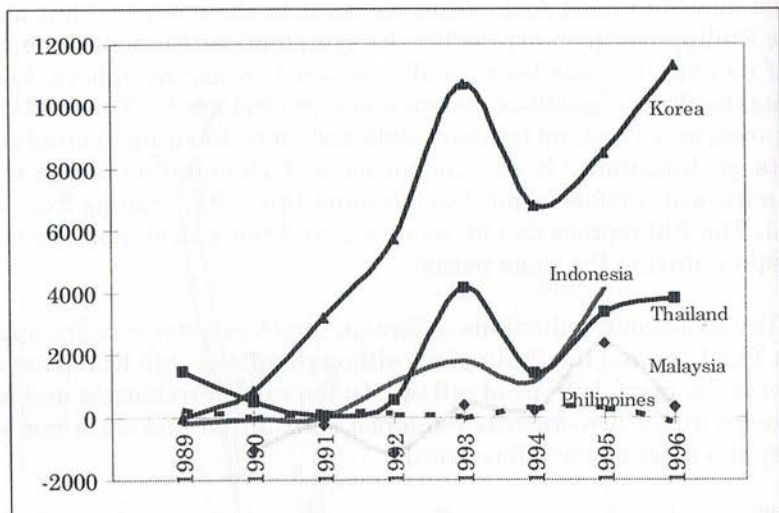
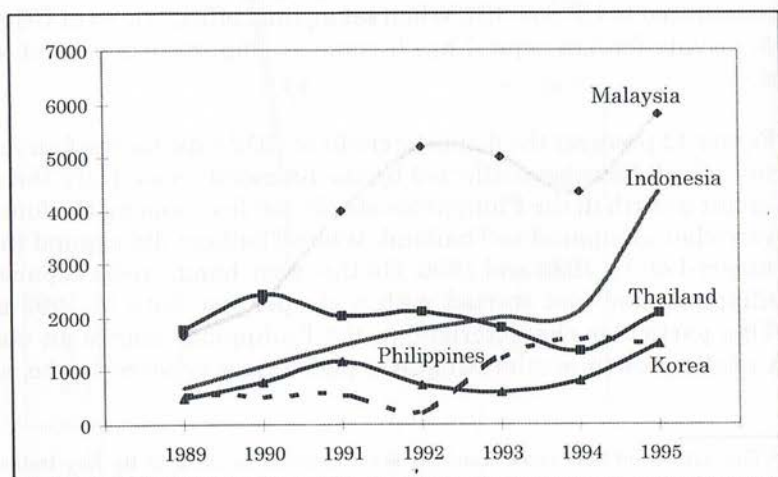


Figure 10.
Foreign Direct Investment
(Million US\$)



Source: ADB Key Indicators of Developing Asia and Pacific Member Countries, 1997

Figure 11.
Net Private Flows
(Million US\$)

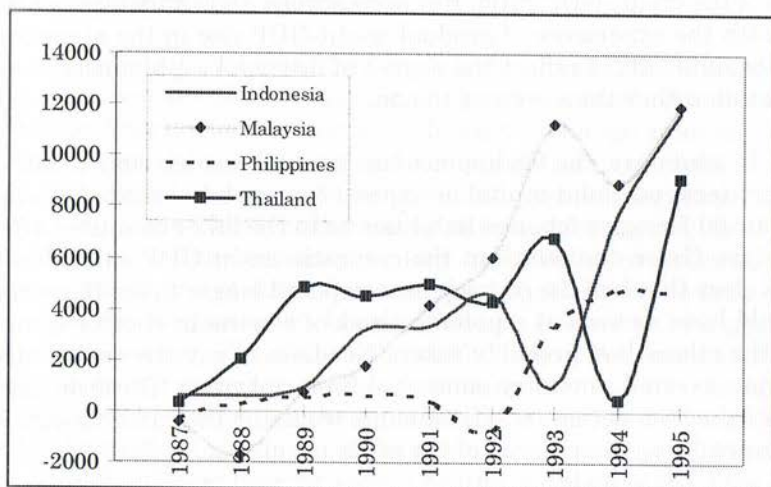
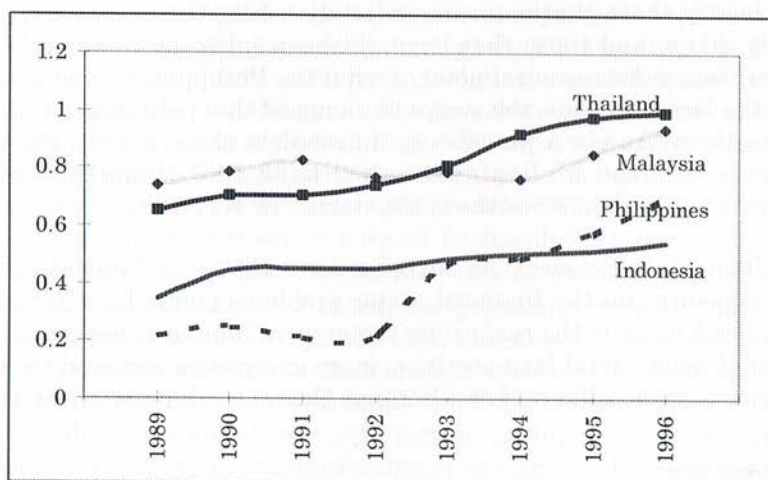


Figure 12.
Domestic Credit/GDP Ratio



Source: ADB Key Indicators of Developing Asia and Pacific Member Countries, 1997

demands from the real sector of the economy implies the excess money appears elsewhere such as real estate and share prices, inflate their values. It is of course possible that there is "monetary deepening" as shown in the shifts of the credit-GDP ratio. But such abrupt and sharp rise is not consistent with the experience of gradual credit-GDP rise in the other countries. The absolute values reflect the degree of financial sophistication and modernization rather than overexpansion.

In summary, the Philippines has not had enough time to either draw in short-term portfolio capital or expand foreign borrowings to accumulate substantial foreign exchange liabilities as in the other countries affected by the crisis. Given the surge in the domestic-credit GDP ratio, however, it seems clear that had the country been exposed longer to the flows of capital it would have arrived at a potential risk of a crisis in shorter span of time than the others had probably taken. Needless to say the early outbreak of the crisis averted a country-generated financial crisis. These do not change the fact that the necessary adjustments would be the same though in a less constrained way as required of the other countries.

4. Policy Responses

In this section we try to document the policy responses of the Philippines to the crisis as it unfolded in the country. One way of looking at them is to classify those that were immediately taken, those that were subsequently taken, and those that have not been taken or meant to consider broader issues. As a general point, even if the Philippines is not directly in crisis, the fact that it has the symptoms suggest that policies are required to address them. Annex A provides an incomplete chronology of the various measures that the Philippines central bank BSP (Bangko Sentral ng Pilipinas) have taken since the crisis started in July 1997.³

Immediate Policies. As early as June 1997, the Central Bank has taken measures on the financial sector problems pointed out in Section 2 above. Bank loans to the real estate sector were limited to not more than 2 percent of banks' total loan portfolio, more cover were required for the foreign exchange liabilities of the Foreign Currency Deposit Units (FCDU

³ The chronology here is not complete since there are pronouncements made by the BSP governor which are not officially recorded. Annex A also ends in December 1997.

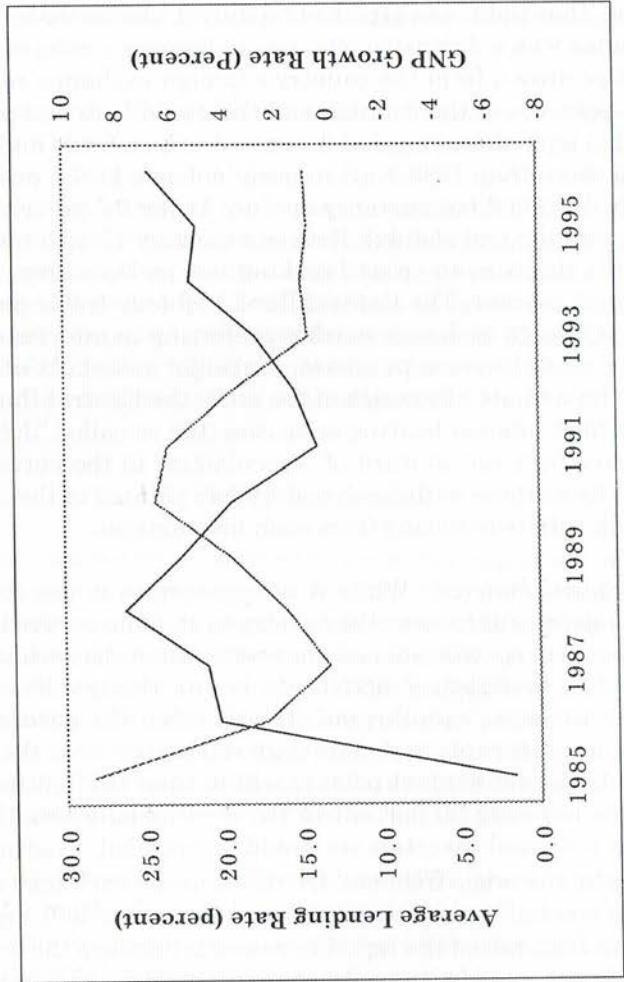
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and guidelines were issued on the duties and responsibilities of bank Board of Directors. And at the end of June, when there was a perceptible pressure in the foreign exchange markets, the Central Bank raised its overnight lending rates by 100 percent (to 34 percent).

As the Thai Baht was attacked on July 2, the immediate response of the Philippines was a defensive one, i.e., to become a residual seller of foreign exchange drawn from the country's foreign exchange reserves. Given the limited reserves of the country and the possible extent of the crisis in Thailand, this immediate response promised to be a futile and costly battle. After losing more than US\$ 1.5B in early defense of the peso, the Philippines finally devalued the currency on July 11 (by 9.7 percent between the end of June and the end of July). Between the July 11 action and the end of the year with the Korean crisis breaking out in December, the peso had devalued by 43 percent. The Central Bank had only feeble participation in the country's foreign exchange market preferring to intervene through the interest rate route (reverse purchase, overnight rates). At one time or another in the immediate aftermath of the crisis the Central Bank floated the proposal for high interest bearing securities (the so-called "Jobo" bills of the 1984-85 currency crisis) to ward off "speculators" in the currency markets. This did not fly as those with fresh history had pointed to the debacle on the Central Bank coffers resulting from such instruments.

Subsequent Policies. While it is appropriate to ask for subsequent policies that are meant to steer the country to an adjusted environment, it is difficult to point to specific policies that were taken. Immediate policies are some kind of a "firefighting" activity to isolate the problem and consider measures for the new "equilibrium". The fact that the government continued to allow interest rates to remain high relative to what they were before the crisis puts the subsequent policies still in their firefighting mode. With interest rates hovering 30 percent in the months following the crisis they suggest that potential investments would be crippled, existing enterprises would be hit by the crisis from two fronts—foreign exchange obligations in local currency terms escalate and interest payments balloon. Indeed, the Central Bank even raised the liquidity reserves between the end of July and the end of August in addition to the statutory reserve requirements raising the costs of investments. Again with the benefit of hindsight it seems clear that the analogous high interest rate regime during the 1984-85 crisis in the Philippines only led to a further economic decline as shown in Figure 13.

Figure 13.
 GNP Growth Rates and Bank Average Lending Rates
 1985-1996



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For sure there were subsequent policies addressing the financial sector, many for actions that have already occurred. They are intended to safeguard the system from similar episodes in the future. For example, there was a reduction in the allowable overbought foreign exchange position of banks, the consolidation of bank accounts with their subsidiaries and affiliates when computing for foreign exchange positions, and the institution of a non-deliverable forward hedging facility.

The Central Bank has proposed a legislative bill to amend the General Banking Act (GBA) which will authorize the Monetary Board to adopt internationally accepted standards relating to risk-based capital requirements, and define, in more specific terms, unsound banking practices. This amendatory bill is supposed to provide a new legal and regulatory framework to face up to the changing environment characterized by mobile capital, and a variety of international financial instruments.

Unattended Policies. It seems obvious that the policy response to the Asian financial crisis has appropriately come from the country's central bank. What is equally obvious is that attention has focussed on policies affecting the banking system even if there is a general acceptance that the crisis has been a financial one (that led to a currency crisis). For example, the foreign exchange liabilities of non-bank financial institutions have been higher than banks yet the measures that have been adopted are aimed at banks. Moreover although the extent of Philippine private firms that have branches abroad is not as significant as in other countries, consolidation of these accounts is also essential to capture the country's overall foreign exchange exposure. In short, policies to reform the financial sector in general are yet to be fashioned.

Nevertheless, the initial defensive response to the crisis has not been undone. This has given rise to the perception in the banking and financial community that the basic rationale for those responses remain the same. Thus interest rates remain high in view of the fact that the central bank itself has not really abandoned the notion of achieving some threshold exchange rate. Until such time that a defensive mode is completely discarded, monetary policy is bound to be hampered.

Other Policies. The sharp depreciation of the currency arising from the Asian financial crisis has created a vacuum of other policies that should recognize its broader implications. The policy response from the country's central bank is only a start of the necessary series of policies that such crisis

requires. Indeed the policies that have been mentioned and detailed in Annex A are supposed to address the root causes of the crisis even if its outbreak took place elsewhere. The fact remains that the financial side of the problems needs attention not directly by the central bank but certainly called attention to by it. In addition there are other policies that need consideration.

First, the potential benefit from the real exchange rate depreciation requires an accompanying wage rate restraint in order to make it effective. The signing of agreements between labor and employers is an important element of such an adjustment.⁴ But an official pronouncement of "benign policy" may be more appropriate. After all, there is every political temptation to yield to popular calls for compensatory adjustment of wages relative to the degree of depreciation.

Second, the effective adjustment of the depreciation also requires an accompanying inflation rate that is less than the degree of exchange rate change. This requires a suitable macroeconomic policy using a combination of monetary and fiscal policies. A regime of high interest rates is one inflationary factor apart from the real side of the economy in the form of supply shortages. In fact the recent history of large devaluation in the Philippines (in 1984-1985) in the end were only marginally effective as inflation escalated to the same degree as the depreciation.

Third, and related to the above, is a government budgetary policy that is both accommodating of the depreciation and promotive of growth that eventually rides out the adjustment. The Philippine government recently imposed mandatory reserves of 25 percent of non-personnel expenditures of the national government, government-owned and controlled corporations, and local government units. While the government attained a small surplus in its operations in 1996 and projected a similar surplus in 1997, this is unlikely to be the case in 1998 and in the next few years as the exchange rate depreciation escalates the debt-servicing component. To avoid putting more pressure on interest rates arising from a budget deficit, the mandatory reserves are supposed to reduce expenditures. Yet this policy, though essential, calls into question whether the adjustment totally hinges on a fiscal surplus that may be growth inhibiting.⁵

⁴ At the economic summit on February 11, the government was reported to have struck a deal with labor and employers on wage restraint.

Finally, there is the necessary associated set of social policies that would ease the burden of the adjustment by vulnerable sectors of the economy. This comes about from the general slowdown expected, the collapse of certain firms and industries severely affected by the exchange rate changes, the return of many Overseas Filipino Workers (OFW) displaced in other countries affected by the crisis (e.g., Malaysia, Korea), and by the transition in employment by those moving from injured sectors to expanding sectors. All these require a widened social safety net supported by government resources.

To help sectors which need a longer time frame to adjust, Philguarantee has been instructed to expand guarantees to affected exporters while the Bankers Association of the Philippines has been asked to consider schemes to relieve borrowers with past due loans without going through protracted legal formalities. The Export Development Facility has been augmented by the central bank. The Social Security System has opened an emergency loan window for returning OFWs affected by the crisis to help their re-employment search in the country. Key programs in the government's Social Reform Agenda are not supposed to be affected by the mandatory cutbacks in their non-personnel expenditures. Tourism is being boosted with the promotion of 1998 as the Centennial Year while Executive Order 264 re-calibrates the tariff reduction for 22 identified industry winners to ease their adjustment to lower tariff rates.

5. Conclusions

Both in-country and regional evidence, as presented here, show that the Philippines did have the symptoms of the "Asian flu" before its outbreak into a full-blown Asian financial crisis. Although it cannot be validated (in a counterfactual sense), one can argue that it may have been the early start of the crisis elsewhere that now makes the country face less harsh consequences and adjustment. The Philippines is therefore not just an innocent bystander in the confluence of events in the region.

⁵ The imposition of budgetary surplus by the IMF in the Asian countries which have had a tradition of surplus does not fit squarely with the usual classification of countries with JOP problems characterized by profligate governments.

This conclusion does not diminish the task of defining policies to address the root causes of the crisis and to adjust to the environment it creates. In terms of policy response it may have been a blessing in disguise that the country did not have sufficient reserves to put up a defense early on. It is this which paved the way for the actual policy of freeing the exchange rate, rather than a conviction that the exchange rate should not be a target. Indeed there are policies which are vestiges of this defense mechanism still in the books (e.g., interest rate cure). On the other hand there remains a policy vacuum in the area of financial sector reforms, the very area that appears to be where the crisis started in the Asian region.

By way of concluding remarks, there are three main areas of concern that result from the crisis in the Philippines. The first is a tendency to consider the re-institution of controls to capital movements the rationale being that these capital movements have been the triggers to the crisis. More specifically, speculative short-term capital movements are characterized by extreme mobility, herd-like behavior, and distort domestic financial parameters. They therefore have to be restricted, or allow only those that the government sanctions.

There are many reasons why this tendency should be avoided. Short term capital speculation is a rational behavior that is not a cause but a consequence of the financial symptoms noted in this paper. "Foreign exchange speculation—like gambling—is nothing but betting which way a price (exchange rate) will go. Speculation does not create the odds, it merely reflects them as best as it can" (de Dios and others, 1998). Punishing speculation by playing into their game would be too costly in financial and social terms. On the other hand, the government deciding on the degree and nature of capital movements assumes it knows better than the market. This has never been borne out of experience or empirical studies. Controlling one account in the Balance of Payments creates distortion to the other items in the accounts. In the case of the Philippines, entertaining the idea of capital controls set back a sustained period of reforms and gives erroneous signal to the global community who the country trades. There are other ways of mitigating the volatile flows of capital, which, while eventually ineffective, are within a macroeconomic framework and without resorting to controls (Lee, 1997; Gleeson and Moreno, 1994; Alburo, 1997). In fact, the more the country should open its capital account to allow market forces to eventually dictate prices and directions. The option of imposing the so-called "Tobin tax" can always be considered in that context.

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A second area of concern is the option of rethinking "globalization". The argument is that with Thailand the most globalized of the Asian countries in crisis, it may never have happened if the countries had exercised more restraint in its pursuit of globalization strategy. The fact of the matter is that globalization has been occurring even before actual official pronouncements of globalization policies. Moreover, globalization has considerably supported the rapid growth of the Asian economies. A fundamental weakness in the financial system was not a product of globalization. Correcting those flaws is the appropriate approach not a retreat from globalization and trade liberalization. Indeed, an extreme consideration of this retreat is to return to agriculture bias in growth. The moment governments start tinkering with sectoral emphases through controls, the likelihood effects may be more counterproductive.

Finally, another area of concern is the credibility of government policies and how markets react to them. More often than not markets are one step ahead of governments and markets have an uncanny way of reflecting credibility. To the extent that policy institutions do not have credibilities, markets discount their pronouncements even if there is every good intention behind them. Credibility however is earned and not acquired. For example the Philippine central bank have made numerous pronouncements of a lower interest rate, have practiced moral suasion to banks to lower the cost of borrowing and has considered various "carrot and stick" options to convince the banking system to lower interest rates. Yet the markets have not followed policy in part because of the perceived lack of firm commitment to allow the exchange rate to be market determined and avoid targeting it through the use of interest rates in addition to the remaining apparatus that has not been set aside. Confidence is therefore also earned the way credibility is. That is a critical starting point in the adjustment to the crisis.

Annex A.
Chronology of BSP Measures

Date	Circular	Measure
5 June 1997	Letter	Limit on bank loans to the real estate sector to not more than 20 percent of banks' total loan portfolio.
6 June 1997	Letter	Required that 30 percent of the 100 percent cover for all foreign exchange liabilities of FCDUs be kept in liquid assets.
6 June 1997	No. 130	Guidelines on responsibilities and duties of bank Board of Directors.
end June 1997		BSP overnight borrowing rates raised from 15 percent to 32 percent; overnight lending rates from 17 percent to 34 percent by mid-July.
22 July 1997	No. 135	Required banks to submit for prior clearance their sales of Non-deliverable forward (NDF) contracts to nonresidents (including offshore borrowing units).
31 July 1997	No. 136	Raised liquidity reserves from 2 percent to 8 percent. The liquidity reserves were imposed on top of the 13 percent statutory reserve requirements.
14 August 1997	No. 139	
27 August 1997	No. 140	

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Annex A (cont.)

Date	Circular	Measure
11 July 1997	No. 137	Reduced banks' allowable overbought foreign exchange position from 20 percent to 10 percent to 5 percent of unimpaired capital or US\$ 10M whichever is lower. Oversold position increased from 10 percent to 20 percent.
11 July 1997	No. 138	Lowered maximum amount of dollars banks can sell over the counter without documents from US\$ 100,000 to US \$25,000.
10 August 1997		BSP temporarily suspended overnight lending facility.
1 September 1997		Consolidation of bank accounts with their subsidiaries and affiliates when computing their net foreign exchange positions.
17 September 1997		
1 October 1997		
1 October 1997	No. 143	Provided for general loan loss provision over and above the provision for possible losses linked to individual identified bad accounts. Banks are now required to put up 2 percent of the gross loan portfolio less loans which are considered non-risk under existing loans/rules as allowance for probable losses.

Annex A (cont.)

Date	Circular	Measure
24 October 1997		Required banks to include only forward sales contracts which have been delivered or consummated to be deducted from computation of dialy foreign exchange position of banks.
22 December 1997	No. 149	Non-deliverable forward (NDF) contracts facility, a hedging facility offered by the BSP through commercial banks to cover or limit the risk eligible borrowers with existing unhedged foreign exchange liabilities to FCDUs.

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